STATEMENT OF THOMAS J. BLILEY, JR.

on behalf of

THE SOUND BANKING COALITION

THE HOUSE FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE OF THE HOUSE FINANCIAL SERVIES COMMITTEE

ILCs – A REVIEW OF CHARTER, OWNERSHIP, AND SUPERVISION ISSUES

July 12, 2006

This statement is submitted on behalf of the Sound Banking Coalition (the Coalition) in connection with the House Financial Institutions and Consumer Credit Subcommittee's hearing regarding industrial loan companies (ILCs). We appreciate the opportunity to submit this statement and thank Chairman Bachus, Ranking Member Sanders and the members of the Subcommittee for holding a hearing on this important issue. In addition, we would like to thank Representative Gillmor and Ranking Member Frank for introducing the Industrial Bank Holding Company Act of 2006. The legislation will go a long way toward correcting the problems caused by the industrial bank loophole, and the Coalition supports it wholeheartedly.

The Sound Banking Coalition is a group of concerned organizations that have come together to try to close the industrial loan company (ILC) loophole to protect consumers and businesses from the problems and the threat to FDIC insurance posed by ILCs. The members of the Sound Banking Coalition are the Independent Community Bankers of America, the National Association of Convenience Stores, the National Grocers Association, and the United Food and Commercial Workers International Union. The members of the Coalition recognized the potential problems posed by the ILC loophole years ago and organized the group in 2003, when there were few applicants for ILC charters.

The ILC loophole allows the mixing of banking and commerce and prevents rigorous supervision of ILC holding companies, threatening the banking system and the federal deposit insurance fund.

In 1987, Congress created a loophole in the federal banking laws that said some banks – specifically, industrial banks – were not banks at all for purposes of federal law.[1] This loophole cut against a fundamental principle of U.S. banking law that has been emphasized by most states and the U.S. Congress – the separation between banking and commerce. When the loophole was created it was not particularly significant because industrial banks were very small, local institutions. Now, however, industrial banks have aggressively expanded their powers and have grown to the point that deposits reach into the billions of dollars and several large corporations own and operate industrial banks. The lack of consolidated supervision of these institutions and the mixing of banking and commerce that occurs when a commercial entity owns a bank threaten some of the basic underpinnings of banking regulation in the United States and could have a significant impact on Coalition members, consumers, and the financial services marketplace as a whole.

The United States has historically kept banking and commerce separate. There are two basic reasons for this approach. One is fairness. Banks are supposed to be neutral arbiters of capital. When banks are owned by commercial entities, however, conflicts of interest can skew loan decisions, unfairly restricting access to capital. This leads to the second reason: safety and soundness. The temptation to favor or discriminate against borrowers (or potential borrowers) based on commercial concerns rather than sound lending principles can lead to systemic problems not only for those seeking capital who are wrongly denied, but also for the financial institutions themselves. FDIC insurance would face significant exposure if the company is granted a bank charter. To the extent the bank or the parent company experienced financial problems, the losses to FDIC insurance could be very large. This is not just a philosophical exercise: Japan provides an explicit example of the dangers of mixing commerce and banking.

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[1] Industrial banks are also known as industrial loan companies (ILCs).

There are a number of ways an ILC can be negatively affected by a commercial parent company:

- financial trouble at the commercial parent or a commercial affiliate can impair the ILCs ability to access necessary capital and credit sources in the financial sector;
- inappropriate inter-company transactions such as excess dividends, manipulation of interest rates, and inappropriate loans, can drain the ILC's capital/profits;
- reputational harm; and
- operational risks from information sharing within the corporate family.

These risks are particularly significant because industrial banks are not subject to the same level of regulatory oversight as banks: they do not face the same consolidated supervision at the holding company level, they do not be subject to consolidated capital requirements, and would be subject to arguably weaker regulatory enforcement. This leaves insufficient safeguards to ensure that this massive company will not endanger FDIC insurance. We question the rationale for this differential treatment of ILCs. As the GAO recently reported to Congress, ILCs "pose similar risks to the bank insurance fund as other types of insured depository institutions." In fact, the same GAO report went further, stating that "from a regulatory standpoint, these ILCs may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company."

- **Consolidated Holding Company Supervision:** Unlike bank holding companies, ILC holding companies are not subject to consolidated holding company supervision. Although the ILC itself is subject to FDIC oversight, the FDIC has more limited regulatory powers with respect to holding companies and affiliates than does the Federal Reserve. The Bank Holding Company Act (BHCA) provides the Federal Reserve with the authority to examine the bank holding company itself and any of its non-bank subsidiaries at any time, while the FDIC has only limited examination authority, and is unable to examine affiliates of banks unless necessary to disclose the direct relationship between the bank and affiliate and the effect of the relationship on the bank.[2]

- **Consolidated Capital Requirements:** The Federal Reserve is also entitled to establish consolidated capital requirements to ensure that bank holding companies are a source of financial strength for the subsidiary bank. This source of strength doctrine has been codified in Regulation Y, which specifies that a bank holding company parent should be ready to provide capital to its bank subsidiary when needed. Failure to provide such assistance would enable the regulator to take enforcement action to protect the bank. In contrast, corporate parents of ILC's are not subject to these capital requirements.
- **Enforcement:** Finally, the Federal Reserve has broad enforcement authority under the BHCA, and can issue cease and desist orders, impose civil penalties, and order a holding company to divest non-bank subsidiaries if it determines that ownership of the subsidiary presents a risk to the financial safety, soundness, or stability of an affiliated bank and is inconsistent with sound banking principles or the purposes of the BHCA.[3] The Federal Reserve is the only federal agency authorized to take such actions against bank holding companies.

The safeguards provided by Federal Reserve regulation are necessary to protect the FDIC insurance against the potential risks presented by a ILC holding companies. Without these safeguards, it may be impossible for problems to be identified and managed in time to prevent deficiencies and damage to the federal safety net. As more and more commercial entities apply for – and are granted – ILC charters, this risk grows ever greater. Simply stated, this is a risk that United States taxpayers should not be forced to take.

The Federal Reserve on numerous occasions has opined on the threat posed by ILCs to the banking system and the insurance fund. In testimony before the Financial Services

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[2] Letter to Senator Tim Johnson from Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, June 25, 2003, at 4.
[3] *Id.* at 5.

Committee in February of this year, newly-appointed Federal Reserve Board Chairman Ben Bernanke urged Congressional review and action with respect to the regulation of ILCs.

The Board's current policy is clearly consistent with the views of former Board Chairman Alan Greenspan. In a letter to Representative James Leach (R-IA) on January 6, 2006, Chairman Greenspan described the current and growing threat to the nation's financial system posed by ILCs.

> When this exemption was adopted in 1987, ILCs were mostly small locally owned institutions that had only limited deposit-taking and lending powers. However, much has changed since 1987 and recent events and trends highlight the potential for this exemption to undermine important general policies established by Congress that govern the banking system and to create an unlevel competitive playing field among banking organizations. The total assets held by ILCs have grown by more than 3,500 percent between 1987 and 2004, and the aggregate amount of estimated insured deposits held by ILCs has increased by more than 500 percent since 1999.
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> The character, powers and ownership of ILCs have changed materially since Congress first enacted the ILC exemption. These changes are undermining the prudential framework that Congress has carefully crafted and developed for the corporate owners of other full-service banks. Importantly, these changes also threaten to remove Congress' ability to determine the direction of our nation's financial system with regard to the mixing of banking and commerce and the appropriate framework of prudential supervision. These are crucial decisions that should not be made

> through the expansion and exploitation of a loophole that is available to only one type of institution chartered in a handful of states.

There is a temptation to assume that because a company is large and well known, and has many assets, it is safe. We have seen this assumption proven wrong time and time again. In fact, if anything, U.S. economic history has often shown that a far different adage typically holds sway – the bigger they are, the harder they fall. Enron, Worldcom, and Kmart provide recent examples. In fact, the latest example is playing out before our eyes as we watch General Motors lose billions of dollars each year and dramatically cut its workforce to try to stay solvent. Fifty years ago no one would have believed that GM would be in the difficult situation it is in today. What will this mean for GM's ILCs? Without regulation by the Federal Reserve that is very hard to say. Perhaps the ILCs are sound and will remain so for years to come – but perhaps not. The problem is that no one really knows because even though GM owns more than one bank it is not subject to consolidated supervision. We are left to wait and see what the future holds. These examples do make one thing clear – size and large revenues do not guarantee safety.

The depth and breadth of the concern about the ILC loophole generally has radiated across the country. In the absence of federal leadership, states are taking matters into their own hands. In part, this is due to Wal-Mart's application for an ILC charter, but it reflects an underlying unease with the steady expansion of ILCs under the loophole. Nearly a dozen states have adopted or are considering legislation that would block or limit ILC holding companies from using ILC charters to open bank branches within their borders. In Iowa, Virginia and Maryland, new laws ban ILC branches on the premises of a commercial affiliate. Laws in Vermont and Wisconsin prohibit ILCs from doing any business in their states. Similar legislation is pending in Illinois and Missouri. Michigan and Pennsylvania have legislation that would specifically bar branches of ILCs chartered in Utah. Kentucky and New York are considering similar legislation. This state activity is indicative of nationwide concerns about this issue.

The state-by-state attention to the issue is not likely to abate, particularly in light of the recently-enacted law in Utah which validates contract language in which borrowers waive their rights to participate in class actions against lenders. This law may be used to cut-off consumer rights not only in Utah, but in other states in which Utah financial institutions do business. In addition, Utah is one of approximately 12 states that has removed the usury ceiling for consumer loans.

The surge of state activity on this issue – and the variety of approaches taken by the states to address the problem – are yet another indication that Congress needs to join this debate. We are encouraged by the introduction this week of the Industrial Bank Holding Company Act by Congressmen Gillmor and Frank. The bill takes a common-sense approach to addressing the huge growth of ILCs and the real threat posed to the safety and soundness of the financial system when these institutions are controlled by commercial entities.

Again, thank you for the opportunity to submit this statement regarding industrial loan company oversight and the ILC loophole. Congressional action on this issue is critical in order to avoid serious threats to competition, the federal deposit insurance fund, and consumer protections. The Gillmor-Frank legislation offers an excellent opportunity to fix the ILC loophole before the threats become major problems.

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